

REPORT OF  
FINANCIAL EXAMINATION

**CORNERSTONE NATIONAL INSURANCE COMPANY**

AS OF  
DECEMBER 31, 2004

STATE OF MISSOURI  
DEPARTMENT OF INSURANCE  
JEFFERSON CITY, MISSOURI

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March 24, 2006  
Columbia, Missouri

Honorable Alfred W. Gross, Commissioner  
State Corporation Commission  
Bureau of Insurance  
Commonwealth of Virginia  
Chair of the NAIC Financial Condition (E) Committee

Honorable Ann Womer Benjamin, Director  
Ohio Department of Insurance  
Secretary of the Midwestern Zone, NAIC

Honorable W. Dale Finke, Director  
Missouri Department of Insurance  
301 West High Street, Room 530  
Jefferson City, MO 65101

Lady and Gentlemen:

In accordance with your financial examination warrant, a comprehensive financial examination has been made of the records, affairs and financial condition of

### **Cornerstone National Insurance Company**

also referred to as "Cornerstone" or as the "Company." The examination was conducted at the Company's home office at 3100 Falling Leaf Court, Suite 200, Columbia, Missouri 65201, telephone number (573) 817-2481. This examination began on November 7, 2005 and concluded March 24, 2006.

### **SCOPE OF EXAMINATION**

#### **Period Covered**

The prior full scope comprehensive financial examination of Cornerstone National Insurance Company was performed as of December 31, 2001. The examination was conducted by examiners from the state of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC) with no other zones participating.

The current full scope association financial examination covers the period from January 1, 2002, through December 31, 2004. The examination was conducted by examiners from the state of Missouri representing the Midwestern Zone of the NAIC. No other zones participated in this examination.

This examination also included material transactions or events occurring after December 31, 2004.

### **Comments Previous Examination**

The comments and recommendations from the prior Report of Financial Examination, as of December 31, 2001, are listed below. The Company's response and the item's current status are also indicated.

#### *Comment:* Intercompany Transactions – Management Agreement

The management agreement between CMP (Cornerstone Management Partners, Inc.) and CNIC (Cornerstone National Insurance Company) states that CMP will provide investment services to CNIC. It is recommended that formal investment guidelines be established to provide a control over the investment decisions of CMP. The guidelines should incorporate investment limitations imposed by Missouri statutes and regulations as well as contain provisions to ensure that the duration and diversification of investments correspond to the underlying insurance product liabilities of CNIC.

#### *Company response:*

The Company has established formal investment guidelines. The guidelines have incorporated investment limitations imposed by Missouri statutes and regulations. The guidelines contain provisions to ensure that the duration and diversification of investments correspond to the underlying insurance product liabilities of the company.

#### *Current findings:*

The Company has established formal investment guidelines that incorporate limitations imposed by Missouri statutes and regulations. The guidelines contain provisions that address the issue of investment diversification and duration.

#### *Comment:* Intercompany Transactions – Federal Income Tax Allocation Agreement

"It was noted that the Company's federal income tax allocation agreement does not specifically state that tax payments made between affiliates under the terms of the agreement are permanent in nature. In order for an exchange of assets or liabilities between affiliates to be considered an "economic transaction" under SSAP 25 (Accounting for and Disclosures about Transaction with Affiliates and Other Related Parties), the transaction must be arms length and permanent in nature. It is recommended that the Company amend its federal income tax allocation agreement to state that tax payments made between affiliates are permanent transactions, which cannot be reversed."

*Company response:*

“The Company has amended Exhibit A of its federal income tax allocation agreement stating that tax payments made between affiliates are permanent transactions that cannot be reversed. An amended copy of Exhibit A is enclosed. Also, a copy of the joint Board Resolution is enclosed and will be presented and ratified at the next scheduled meeting of the Board(s) on November 15, 2002.”

*Current findings:*

The Company amended Exhibit A as indicated. The resolution was ratified by the Board on November 15, 2002.

*Comment: Reinsurance Ceded – Current Accrual*

“It is recommended that the Company initiate a procedure to ensure that a reasonable accrual is established for adjustable reinsurance items in future statutory financial statements.”

*Company response:*

“The Company has implemented a procedure to ensure that a reasonable accrual is recorded for adjustable reinsurance items.”

*Current findings:*

The Company’s year-end 2004 financial statement reflects an accrual for adjustable reinsurance items.

*Comment: Guaranty Fund Deposits*

“The Company should not report Missouri guaranty fund deposits as admitted assets in future Annual Statement filings.”

*Company response:*

“The Company did not report Missouri guaranty fund deposits as admitted assets in its Quarterly Statement dated 06/30/2002 and will not report in future Quarterly or Annual Statement filings.”

*Current findings:*

The Company did not report guaranty fund deposits as admitted assets in its financial statements during the examination period.

RSMo 375.774, Certificate of contribution, has been amended since the prior examination. Guaranty fund contributions are now admissible as assets. This change comports with SSAP 35, Guaranty funds and other assessments.

## HISTORY

### General

Cornerstone was organized as a stock insurer under Chapter 379 RSMo (Insurance Other than Life) on March 6, 1997. The Company was formed as a wholly-owned subsidiary of Cornerstone Management, a Missouri corporation. Cornerstone is currently licensed by the Missouri Department of Insurance to write property and casualty insurance as set forth in its Certificate of Authority.

### Capital Stock

Cornerstone's articles of incorporation authorize the issuance of up to 12,000 shares of common stock with a par value of \$100 per share. The Company was originally capitalized with \$1,200,000 in common stock and \$1,200,000 in contributed surplus. Cornerstone Management owns all shares of Cornerstone's capital common stock. Additional capital contributions made since inception are as follows (there were no capital contributions in 2004):

1997	\$	1,408,361
1998		1,164,276
1999		1,252,000
2000		2,600,000
2001		1,750,000
2002		2,800,000
2003		100,000
2004		-
Total	\$	<u>11,074,637</u>

### Dividends

The Company has not declared or paid any dividends since beginning operations in 1997.

### Management

The articles of incorporation provide for a board of directors comprised of not less than nine persons or more than twenty-five persons. On April 25, 2003, the by-laws were amended, fixing the number of directors at fourteen. At December 31, 2004, the board consisted of the following members, duly elected at the annual meeting of the stockholders.

<u>Name</u>	<u>Business Affiliation</u>
Daniel H. Allen Columbia, MO	Vice President-Underwriting Cornerstone Management Partners Inc.

Greg K. Fick Columbia, MO	Vice President, Treasurer and Asst Secretary Cornerstone Management Partners Inc.
David S. Forrest Columbia, MO	Vice President-Claims and General Counsel Cornerstone Management Partners Inc.
James C. French Columbia, MO	President Cornerstone Management Partners Inc.
Andrew R. Gingrich Columbia, Mo	Accountant MBS Textbook Exchange, Inc.
James E. Godfrey, Jr. Columbia, MO	Attorney Private Practice
Brian G. Harrison Columbia, MO	Insurance Agent Harrison Agency
Earl P. Holland Columbia, MO	Vice Chairman of the Board Cornerstone Management Partners Inc.
Dale W. Hotze Columbia, MO	Chief Executive Officer AFM International, Inc.
Roger G. McKee Columbia, MO	Vice President-Marketing Cornerstone Management Partners Inc.
Robert W. Reid Columbia, MO	Vice President-Public Relations Cornerstone Management Partners Inc.
James M. Silvey Columbia, MO	Chairman of the Board-Emeritus Cornerstone Management Partners Inc.
Roger D. Walker Columbia, MO	Senior Vice President-Operations Cornerstone Management Partners Inc.
John W. Wooldridge Columbia, MO	Vice President-Marketing and Secretary Cornerstone Management Partners Inc.

Officers elected and serving as of December 31, 2004 were as follows.

<u>Name</u>	<u>Office</u>
James C. French	President
Roger D. Walker	Senior Vice President
Greg K. Fick	Vice President, Treasurer, Asst. Secretary
John W. Wooldridge	Vice President-Marketing, Secretary
Daniel H. Allen	Vice President-Underwriting
David S. Forrest	Vice President-Claims, Asst. Secretary, General Counsel
Robert W. Reid	Vice President-Public Relations
Craig A. Van Matre	Assistant Secretary



## **Conflict of Interest**

Cornerstone has a policy requiring officers and directors to complete conflict-of-interest disclosure statements on an annual basis. However, signed conflict-of-interest disclosure statements were not completed by Company personnel for the years under examination. The Company should ensure that signed conflict-of-interest disclosure statements are executed annually by all officers and directors.

## **Corporate Records**

Cornerstone's articles of incorporation and by-laws were reviewed. The minutes of the board of directors and shareholders meetings for the period under examination were also reviewed. The minutes appear to properly reflect and approve corporate transactions and events for the period under examination. Affidavits attesting to the receipt of the examination report were completed by all directors as required by RSMo 374.205.3(4) (Examination, director may conduct when, required when).

As stated above, the Company's by-laws were amended on April 25, 2003 to set the number of directors at fourteen. The amendment was properly submitted to the Missouri Department of Insurance.

## **Acquisitions, Mergers and Major Corporate Events**

The Company was not directly involved in any acquisitions, mergers or major corporate events during the current examination period.

## **Surplus Debentures**

On April 23, 2004, the board of directors approved a resolution authorizing the issuance of a \$5,000,000 surplus note. On June 23, 2004, the Missouri Department of Insurance approved the issuance of the \$5,000,000 surplus note. The note pays interest quarterly on the 15<sup>th</sup> of February, May, August and November at a variable rate tied to the London Inter-Bank Overnight Rate (LIBOR). Interest payments are made subject to the prior approval of the Missouri Department of Insurance. For 2004, the Company paid a total of \$106,827 in surplus note interest.

## **AFFILIATED COMPANIES**

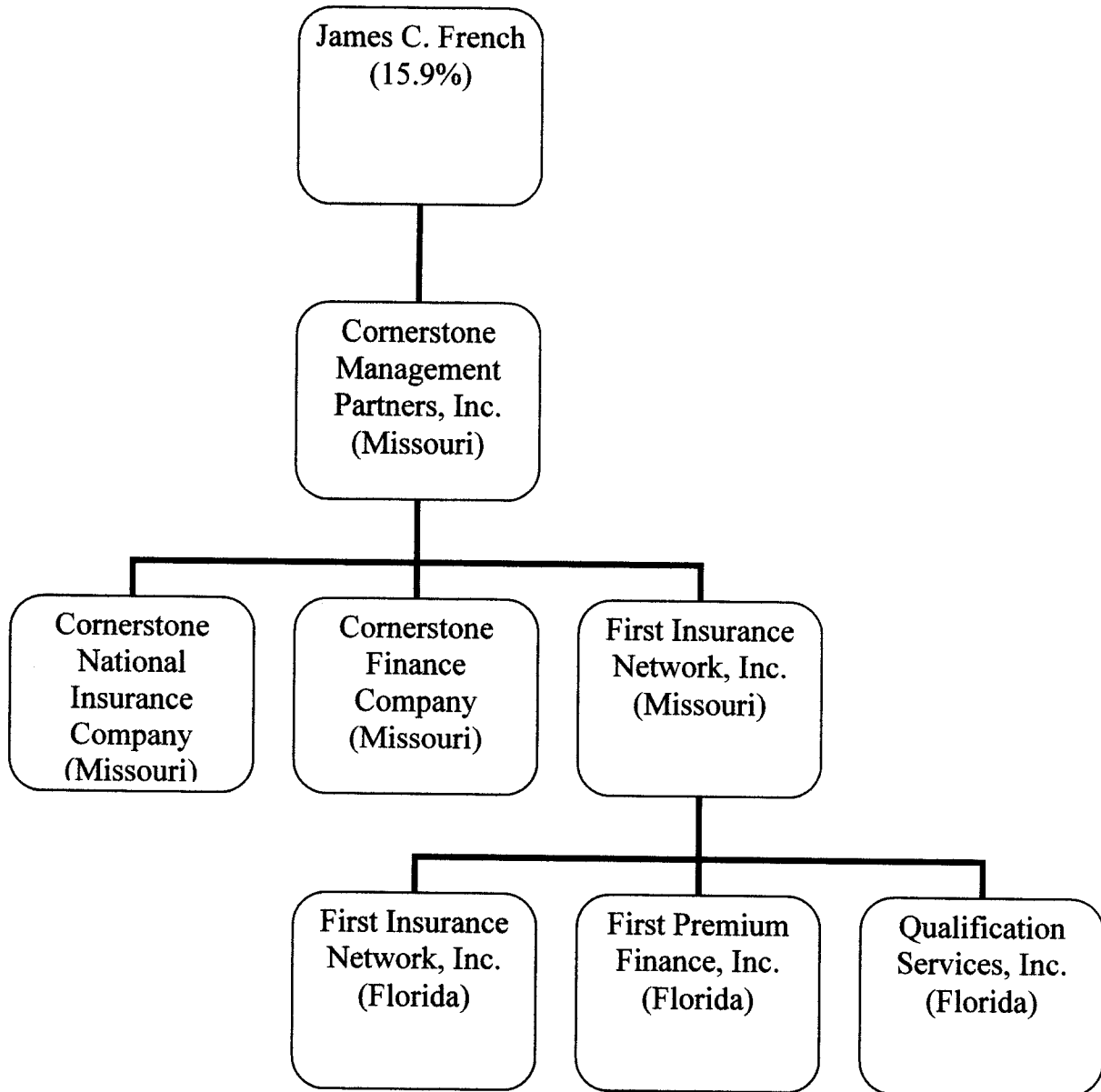
### **Holding Company, Subsidiaries and Affiliates**

Cornerstone is a member of an Insurance Holding Company System as defined by Section 382.010 RSMo (Definitions). Cornerstone is a wholly owned subsidiary of Cornerstone Management Partners, Inc., (Cornerstone Management). James C. French, an individual, owns 15.9% of the outstanding stock of Cornerstone Management, making him the ultimate controlling person.

Insurance Holding Company System annual registration forms were filed by Cornerstone Management on behalf of the Company for each year under examination.

## Organizational Chart

The following organizational chart depicts the holding company system at December 31, 2004. All subsidiaries are wholly owned unless otherwise indicated.



## **Intercompany Transactions**

### Management Agreement

The Company entered into a management agreement with its parent effective March 19, 1997. Services to be provided under this agreement include, but are not limited to, facilities and the following types of services:

- marketing and advertising
- underwriting, strategic planning, policy administration and claims settlement services
- accounting, actuarial and tax reporting
- investment functions
- legal services
- human resources and public relations

According to the terms of the agreement, Cornerstone will pay to Cornerstone Management expenses incurred by Cornerstone Management in connection with Cornerstone Management's advice and services including: salaries and benefits of Cornerstone Management employees performing duties for the Company; eighty-nine percent (89%) of office overhead expenses for rent and utilities; any actual out-of-pocket expenses; costs of information services and data processing including systems development and consulting fees. Amounts incurred by the Company under this agreement for the years under examination were as follows:

2002	\$ 3,007,890
2003	\$ 3,378,481
2004	\$ 3,535,561

### Federal Income Tax Allocation Agreement

Effective February 25, 1998, Cornerstone Management and its affiliates entered into a federal income tax allocation agreement for the tax year 1997 and subsequent tax periods. Under this agreement federal income tax is based upon the amount of federal income tax which would be payable by the Company if each party to the agreement filed a separate tax return. Any amount to be paid by Cornerstone to Cornerstone Management or by Cornerstone Management to Cornerstone is paid quarterly based upon the Company's estimated tax asset or liability.

The federal income tax allocation agreement was amended February 4, 1999 to include a provision to settle the entire tax asset or liability at the end of each year. This provision states that the Company will pay to or receive from Cornerstone Management, as a tax compensating payment, the full amount that Cornerstone would have paid or received had the parties filed separate tax returns.

The allocation agreement was amended again in November 2002 to stipulate that tax payments between affiliates are permanent. This amendment was made in response to the prior Missouri Department of Insurance financial examination.

### **FIDELITY BOND AND OTHER INSURANCE**

The Company is a named insured on a financial institution bond that provides \$500,000 in coverage for a single loss due to employee dishonesty with an aggregate limit of \$1,000,000. The policy has a deductible of \$10,000 per loss. This coverage complies with the suggested minimum amount of fidelity insurance recommended by the National Association of Insurance Commissioners (NAIC).

The Company is also a named insured on the following policies:

<u>Coverage</u>	<u>Limit</u>
Employment Liability	\$3,000,000 per loss \$6,000,000 aggregate
Fiduciary Liability	\$3,000,000 per loss \$6,000,000 aggregate
Directors and Officers Liability	\$3,000,000 per loss \$6,000,000 aggregate
Outside Directorship Liability	\$3,000,000 per loss \$6,000,000 aggregate
Premises Coverage	\$221,685
General Liability	\$1,000,000 each occurrence \$2,000,000 aggregate
Workers Compensation	Statutory-MO
Employers Liability	\$100,000 each accident
Commercial Excess and Umbrella	\$5,000,000 aggregate

## EMPLOYEE BENEFITS

Cornerstone has no employees. Personnel are employed by Cornerstone Management to perform administrative functions in accord with the management agreement described above. Cornerstone Management offers its employees a variety of benefits, including health insurance, short-term and long-term disability insurance, life insurance, dependent group life insurance, dental insurance, a 401(k) program and an employee stock ownership plan (ESOP).

## STATUTORY DEPOSITS

### Deposits with the State of Missouri

The funds on deposit with the Missouri Department of Insurance as of December 31, 2004, as reflected below, were sufficient in par and market value to meet the deposit requirements for the state of Missouri per Section 379.098 RSMo (Securities to be deposited by all companies, kind and amount).

<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
U.S. Treasury Note	\$ 330,000	\$ 334,917	\$ 332,662
U.S. Treasury Note	330,000	337,590	329,863
U.S. Treasury Note	330,000	351,186	339,018
Phelps County MO Hosp	350,000	350,578	350,000
Totals	<u>\$ 1,340,000</u>	<u>\$ 1,374,271</u>	<u>\$ 1,351,543</u>

### Deposits with Other States

Cornerstone also has funds on deposit with other states in which it is licensed. Those funds on deposit as of December 31, 2004 were as follows:

<u>State</u>	<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
Arkansas	Atlanta GA Airport Rev	\$ 150,000	\$ 148,410	\$ 148,145
Oklahoma	Columbia MO SD	350,000	341,985	346,930
Totals		<u>\$ 500,000</u>	<u>\$ 490,395</u>	<u>\$ 495,075</u>

## INSURANCE PRODUCTS AND RELATED PRACTICES

### Territory and Plan of Operations

At year-end 2004, Cornerstone was licensed in four states: Arkansas, Florida, Missouri and Oklahoma. In Missouri, the Company is licensed as a multiple line carrier for property and casualty insurance by the Missouri Department of Insurance under Chapter 379 RSMo (Insurance other than life). In Arkansas, Missouri and Oklahoma, Cornerstone markets private passenger automobile insurance through a network of approximately 470 independent agencies. In Florida, the Company employs a managing general agent ("MGA"), National Insurance Service Plan, to market private passenger automobile insurance.

### Policy Forms, Underwriting, Advertising and Treatment of Policyholders

The Missouri Department of Insurance has a market conduct staff that performs a review of these issues and generates a market conduct report. The most recent market conduct examination report covered the period from January 1 through December 31, 2004 and was issued in May 2005. The report did not disclose any control weaknesses or statutory violations that would materially impact the Company's financial condition.

## REINSURANCE

### General

The Company's reinsurance and premium activity on a direct written, assumed and ceded basis for the period under examination is detailed below:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Direct written premiums	\$ 28,698,834	\$ 27,749,435	\$ 29,305,917
Reinsurance ceded:	<u>(6,571,940)</u>	<u>(7,709,829)</u>	<u>(12,228,492)</u>
Net written premiums	<u>\$ 22,126,894</u>	<u>\$ 20,039,606</u>	<u>\$ 17,077,425</u>

### Assumed

Cornerstone entered into a fronting arrangement with Virginia Surety Company, Inc., (Virginia Surety) effective November 1, 1998. Under the agreement, Virginia Surety ceded 100% of business written in the state of Arkansas to the Company beginning January 1, 1999. Virginia Surety received a 4% fronting fee for business written under the agreement. This arrangement was terminated effective December 31, 2000 when the Company received a certificate of authority in the state of Arkansas. Cornerstone began writing business on a direct basis in Arkansas on January 1, 2001. The business that was assumed under the fronting arrangement is currently in run-off.

## **Ceded**

### **Quota Share Agreement**

At year-end 2004, Cornerstone participated in a quota share agreement with various reinsurers. Guy Carpenter, the Company's reinsurance intermediary, placed the coverage. Under the agreement, Cornerstone cedes 20% of all auto liability and auto physical damage premiums written. The agreement provides for a 28% provisional ceding commission based upon a 64.5% loss ratio. Actual commission may vary from a minimum 20% to a maximum 37% based upon loss ratios ranging from 72.5% to 52.5%. The agreement also allows the Company to change its ceding percentage on the first day of January, April, July or October with 30 days prior written notice to the reinsurer. Ceding percentages range from a minimum 20% to a maximum 35%. A special provision in the agreement limits premiums written in Florida to \$600,000 (20% of \$3,000,000) each underwriting year.

### **Excess of Loss Agreement**

Cornerstone's intermediary has secured excess of loss coverage with various authorized reinsurers for the Company's auto liability business. Coverage is provided in three layers. The first layer provides maximum coverage of \$430,000 in excess of the Company's retention of \$70,000 per occurrence. The second layer provides coverage up to \$1,000,000 in excess of \$500,000 per occurrence. The third layer provides coverage up to \$1,500,000 in excess of \$1,500,000 per occurrence. The excess of loss coverage costs 4.75% of subject net earned premium for the first layer; .375% of subject net earned premium for the second layer; and, .275% of subject net earned premium for the third layer. Deposit premiums are payable quarterly. The minimum premium is \$776,000. Reinstatements for the first two layers are unlimited and free. Reinstatement for the third layer is limited to one at 100%, the amount pro-rated.

### **Catastrophe Agreement**

Cornerstone's catastrophe agreement provides coverage up to 95% of \$1,000,000 in excess of the Company's \$300,000 retention. The reinsurer's maximum liability for all losses under the agreement is limited to \$1,900,000 (95% of \$2,000,000). The cost of the coverage is 2.47% of subject net earned premium with a minimum premium of \$114,000.

## **ACCOUNTS AND RECORDS**

Cornerstone prepares its financial statements based on statutory accounting principles. Accounting entries are recorded using QuickBooks accounting software. The Company uses Policy Tracking System software for premium billing, policy administration and claims administration.

Deloitte and Touch, LLP, a public accounting firm, audits the Company's financial statements on an annual basis. The most recent audit work papers were reviewed. The work papers were used in the course of the examination as deemed appropriate.

Mark A. Doepke, FCAS, MAAA, reviewed and certified the reserves and related actuarial items reported in the financial statements. Mr. Doepke is president of Actuarial Advisors, Inc.

The Missouri Department of Insurance retained a consulting actuary, Jon W. Michelson, FCAS, MAAA, to review the adequacy of the Company's reserves and related liabilities. Mr. Michelson is associated with Expert Actuarial Services, LLC.

The consulting actuary made the following recommendations: (1) the Company should closely monitor case reserve adequacy; and (2) the Company should separately track and analyze new or different lines of business (e.g., Florida) in order to identify and react to issues arising from changes in development.

### **FINANCIAL STATEMENTS**

The following financial statements, with supporting exhibits, present the financial condition of the Company as of December 31, 2004, and the results of operations for the fiscal period then ended. Any examination adjustments to the amounts reported in the financial statements or comments regarding such are made in the "Notes to the Financial Statements" which follow the financial statements.

There may have been additional differences found in the course of this examination which are not shown in the "Notes to the Financial Statements." These differences were determined to be immaterial in relation to the financial statements, and therefore were only communicated to the Company and noted in the work papers for each individual financial statement item.



## ASSETS

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	\$ 21,727,937	\$ -	\$ 21,727,937
Preferred stocks	5,274	-	5,274
Common stocks	1,248,507	-	1,248,507
Cash	3,996,584	-	3,996,584
Other invested assets	884,796	-	884,796
Receivable for securities	153,347	-	153,347
Investment income due and accrued	246,078	-	246,078
Premiums in course of collection <b>NOTE 1</b>	3,457,519	-	3,457,719
Amounts recoverable from reinsurers	906,523	-	906,523
Net deferred tax asset	56,069	-	56,069
Totals	<u>\$ 32,682,634</u>	<u>\$ -</u>	<u>\$ 32,682,634</u>

## **LIABILITIES, SURPLUS AND OTHER FUNDS**

Losses	\$ 7,799,965
Loss adjustment expenses	520,510
Commissions payable; contingent commissions and other similar charges <b>NOTE 1</b>	1,007,890
Other expenses	5,682
Taxes; licenses and fees	47,665
Current federal and foreign income taxes	76,539
Unearned premiums	6,526,751
Ceded reinsurance premiums payable	220,507
Payable to parent, subsidiaries and affiliates	265,557
Payable on paid losses and loss adjustment expenses to Florida MGA	<u>52,338</u>
Total Liabilities	\$ 16,523,404
Common capital stock	\$ 1,200,000
Surplus notes	5,041,464
Gross paid in and contributed surplus	12,274,637
Unassigned funds (surplus)	<u>(2,356,871)</u>
Total Capital and Surplus	\$ 16,159,230
Total Liabilities and Capital and Surplus	<u><u>\$ 32,682,634</u></u>

## STATEMENT OF INCOME

Premiums earned	\$ 20,857,679
Losses incurred	(11,686,695)
Loss expenses incurred	(1,493,093)
Other underwriting expenses incurred	<u>(7,001,258)</u>
Net underwriting gain	\$ 676,633
Net investment income earned	\$ 608,692
Net realized capital gains	<u>59,327</u>
Net investment gain	\$ 668,019
Net (loss) from agents' or premium balances charged off	\$ (72,353)
Finance and service charges not included in premiums	831,355
Rewrite fee	<u>34,400</u>
Net other income	\$ 793,402
Net income before federal and foreign income taxes	\$ 2,138,054
Federal and foreign income taxes incurred	<u>(766,539)</u>
Net income	<u><u>\$ 1,371,515</u></u>

## CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders; December 31 prior year	\$ 9,687,543
Net income	\$ 1,371,515
Change in net unrealized capital gains or (losses)	105,494
Change in net deferred income tax	(5,322)
Change in surplus notes	5,041,464
Accrued but unapproved interest on surplus note	(41,464)
Examination changes	-
Change in surplus as regards policyholders for the year	\$ 6,471,687
Surplus as regards policyholders; December 31 current year	<u><u>\$ 16,159,230</u></u>

## EXAMINATION CHANGES

Surplus as regards policyholders per Company, December 31, 2004:

Common capital stock	\$ 1,200,000
Surplus notes	5,041,464
Gross paid in and contributed surplus	12,274,637
Unassigned funds (surplus)	<u>(2,356,871)</u>
Total surplus as regards policyholders	\$ 16,159,230

		INCREASE IN <u>SURPLUS</u>	DECREASE IN <u>SURPLUS</u>
Premiums in course of collection	Note 1	705,702	
Commissions payable	Note 1	<u>-</u>	705,702
Totals		705,702	<u>705,702</u>
Net Increase/(Decrease) in surplus			<u>-</u>

Surplus as regards policyholders per Examination, December 31, 2004:

Common capital stock	\$ 1,200,000
Surplus notes	5,041,464
Gross paid in and contributed surplus	12,274,637
Unassigned funds (surplus)	<u>(2,356,871)</u>
<b>Total Capital and Surplus</b>	<b>\$ 16,159,230</b>

## NOTES TO FINANCIAL STATEMENTS

<b>NOTE 1</b>	<b>Premiums in course of collection</b>	<b>3,457,719</b>
	<b>Commissions payable</b>	<b>1,007,890</b>

Cornerstone reported \$705,702 of commissions payable as an offset to premiums in course of collection. SSAP 64, Offsetting and netting of assets and liabilities, prohibits such netting when no legal right of offset exists. The above reclassification shows the proper presentation of premiums and commissions.

## **GENERAL COMMENTS OR RECOMMENDATIONS**

### Conflict of Interest

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As noted above, conflict of interest disclosure statements were not completed for the years under examination, 2002 through 2004. Conflict of interest disclosure statements were completed for 2005. The Company should ensure that officers, directors and key employees complete conflict of interest disclosure statements annually.

### Accounts and Records

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The consulting actuary made the following recommendations: (1) the Company should closely monitor case reserve adequacy; and (2) the Company should separately track and analyze new or different lines of business (e.g., Florida) in order to identify and react to issues arising from changes in development. The Company should implement these recommendations.

### Notes to Financial Statements

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The Company incorrectly netted commissions payable against premiums in course of collection. SSAP 64 prohibits such treatment when no legal right of offset exists. The Company should ensure that netting entries are only made when a legal right of offset exists.

## **SUBSEQUENT EVENTS**

On August 26, 2005 the articles of incorporation were amended, changing the capitalization of the Company from 12,000 shares of \$100 par value common stock (\$1,200,000) to 15,000 shares of \$100 par value common stock (\$1,500,000). The Missouri Secretary of State approved the change on October 5, 2005. The Company increased its capitalization to meet the minimum capital requirements of the State of South Carolina.

In 2005, the Company became licensed in the following states: Arizona, Colorado, Kansas, Louisiana, South Carolina and Texas. At year-end 2005, the Company had yet to write any premium in any of the above states.

Also in 2005, the Company's affiliate, Keystone Group Insurance Services, Inc., f/k/a Keystone Specialty Insurance Group, Inc., began operations in Florida. Keystone Group Insurance Services, Inc. was established as a managing general agent. Keystone Group Insurance Services, Inc. is a wholly owned subsidiary of First Insurance Network, Inc. (Missouri), which is a wholly owned subsidiary of Cornerstone Management.

## ACKNOWLEDGMENT


The assistance and cooperation extended by Cornerstone National Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Richard Hayes, CFE, and Joseph Hofmeister, examiners for the Missouri Department of Insurance participated in this examination.

## VERIFICATION

State of Missouri )  
 ) ss  
City of St. Louis )

I, Thomas J. Cunningham, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of the Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

Carol A. Walter  
NOTARY PUBLIC - NOTARY SEAL  
State of Missouri  
County of Jefferson  
My Commission expires 3-26-06

  
Thomas J. Cunningham, CPA, CFE  
Examiner-in-Charge  
Missouri Department of Insurance


Sworn to and subscribed before me this 20 day of MARCH 2006.  
My commission expires: \_\_\_\_\_

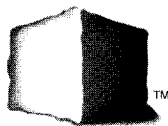
3-26-06

Carmel A. Walter  
Notary Public

## SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with the National Association of Insurance Commissioners procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.

  
Christiana Dugopolski, CPA, CFE  
Audit Manager  
Missouri Department of Insurance



**CORNERSTONE**  
national insurance company

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APR 19 2006

April 19, 2006

Kirk Schmidt, CFE, CPA  
Missouri Department of Insurance  
Harry S. Truman State Office Building  
301 West High  
Jefferson City, Missouri 65101

Dear Mr. Schmidt,

As ordered, Cornerstone National Insurance Company (the Company) has implemented or addressed each item mentioned in the General Comments and/or Recommendations section of the Examination Report for the three-year period ending December 31, 2004. Each item is discussed below:

**Conflict of Interest (Page 6)**

The Company will ensure that officers, directors and key employees complete conflict of interest disclosure statements continuing in 2006 and annually thereafter.

**Accounts and Records (Page 12)**

The Company (1) has and will continue to monitor case reserve adequacy; and (2) will separately track and analyze new states (e.g., Florida) or different lines of business in order to identify and react to issues arising from changes in development.

**Notes to Financial Statements (Page 17)**

Beginning with the 2006 quarterly statement and annual statement filings, the Company will ensure that commissions payable will not be netted against premiums in course of collection. This will be in accordance with SSAP 64.

Cornerstone National Insurance Company requests that this response be included in the report as a public document.

Sincerely,

James C. French  
President and CEO  
Cornerstone National Insurance Company